

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.

Debtors

CASE NO. 96-61376

Chapter 11

Substantively Consolidated

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

Presently before the Court is the Motion (the "Motion for Relief") of ESB Bank, F.S.B., (the "Bank"), successor to both Economy Savings Association and Ellwood Federal Savings Bank, to Prohibit Use of Cash Collateral, For Sequestration of Rents, Adequate Protection or Relief From the Automatic Stay, pursuant to §§ 362(d) and 363 of the Bankruptcy Code, 11 U.S.C. §§ 101 - 1330 (the "Code"). The Bank seeks an order allowing it to enforce certain rights and remedies alleged to exist by virtue of various equipment leases (the "Leases") which were

allegedly either sold¹ or collaterally assigned to the Bank by The Bennett Funding Group, Inc. (the "Debtor" or "BFG").

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and subject matter of this contested matter by virtue of 28 U.S.C. §§ 1334(b), 157(a), (b)(1), (b)(2)(A), (G) and (O).

BACKGROUND

The Bank's Motion for Relief was filed on April 25, 1996. On April 26, 1996, the Court *sua sponte* issued an Omnibus Order pursuant to Code § 362(e) deferring the final hearing on the Bank's Motion for Relief, as well as the final hearings on numerous other motions for relief from the automatic stay which had been filed by various banks, to August 15, 1996.² That Order has been extended *sua sponte* from time to time without objection by any party in interest.

On May 22, 1996, an Order was entered granting the Bank provisional relief pending final

¹ For purposes of ruling on the Bank's Motion for Relief, the Court will treat the leases as having been assigned. Ownership of property is not a basis for relief from the automatic stay, which generally prohibits acts being taken against property in which either the debtor or the estate has an interest. *See* 11 U.S.C. § 362(a).

² In its Omnibus Order, the Court noted that it had been advised that approximately 200 banks had claimed a security interest in various equipment leases and that thousands of investor creditors had also claimed interests in some of the same leases. The Court concluded that there were compelling circumstances "based on their numerosity and the burden said motions place on the Debtors and/or the Trustee at this stage of the case . . ." for extending the time for the final hearing.

disposition of the Motion for Relief by enjoining the Trustee from disposing of or in any way transferring the Leases or any of the rental payments therefrom, and requiring the Trustee to, *inter alia*, deposit all rental payments into a segregated account and to provide an accounting of such collections (the "Segregation Order").

On July 15, 1996, Richard C. Breeden (the "Trustee"), the trustee appointed in these cases, filed an Objection to the Bank's Motion for Relief. As required by the Court's Memorandum-Decision, Findings of Fact, Conclusions of Law and Order dated October 22, 1996, *see In re Bennett Funding Group, Inc.*, 203 B.R. 30 (Bankr. N.D.N.Y. 1996) (the "October Decision"), the Trustee filed a Particularized Response to the Bank's Motion on December 9, 1996.

On December 31, 1996, the Court issued an Order Scheduling Evidentiary Hearing and Requiring Presentation of Evidence by Declarations/Depositions, which the Court amended on February 5, 1997 by an Amended Order Scheduling Evidentiary Hearing and Requiring Presentation of Evidence by Declarations/Deposition (the "Amended Scheduling Order"). The Amended Scheduling Order required that each party present the testimony of its witnesses through the submission of written declarations or transcribed depositions, under penalty of perjury, and admissible under the Federal Rules of Evidence, which were to constitute the direct testimony of the proffering witnesses. As a condition of admissibility of such testimony, the declarant/deponent was required to be present at the evidentiary hearing (the "Hearing") on the Motion for Relief and subject to cross-examination. The parties were also afforded the opportunity to file evidentiary objections in connection with the declarations/depositions, as well as a pre-hearing memorandum of law.

The Hearing was held on April 23, 1997, and the matter was submitted for decision at the close of evidence that day.³

FACTS

On March 29, 1996 (the "Petition Date"), the Debtor and three of its related corporate entities, namely Bennett Receivables Corporation, Bennett Receivables Corporation II and Bennett Management and Development, voluntarily filed petitions for relief under Chapter 11 of the Code. On April 18, 1996, the Trustee was appointed by the United States Trustee pursuant to Code § 1104, and said appointment was approved by the Court that same day.

Prior to filing, the Debtor was in the business of originating, purchasing and selling commercial leases of copy machines and other office equipment. The Debtor financed its operations in part by compiling certain of these leases into portfolios which were then sold or assigned to banks as collateral for loans. The Debtor sold or collaterally assigned ten such lease portfolios to the Bank in connection with ten financing transactions in which the Bank advanced

³ On April 23, 1997, the Court *sua sponte* entered an Order extending the date by which it was required to issue a decision on, *inter alia*, the Bank's Motion for Relief to sixty (60) days following the conclusion of the Hearing. Ultimately, the Court issued an Order dated July 1, 1997 extending the date for a decision on the Motion for Relief, and continuing the stay in effect, until at least fifteen (15) days after the Court had heard Marine Midland Bank's ("Marine's") pending motion for reconsideration of a decision denying Marine's motion for relief from the automatic stay. On August 11, 1997, the Court issued a decision granting Marine's motion for reconsideration and granting Marine relief from the stay. *See Marine Midland Bank v. The Bennett Funding Group, Inc. (In re The Bennett Funding Group, Inc.)*, No. 96-61376, Adv. Pro. 96-70061 (Bankr. N.D.N.Y. Aug. 11, 1997) (the "Reconsideration Decision"). On August 21, 1997, the Trustee filed a motion to stay the issuance of any further rulings Code § 362 motions in this case pending appeal of the Reconsideration Decision. At a hearing held on August 26, 1997, the Court denied the Trustee's motion.

to the Debtor an aggregate principal amount of \$4,249,875.25.

In connection with each transaction, the Debtor executed and delivered to the Bank, *inter alia*, a Promissory Note in the amount advanced (*see* ESB's Exhibits 1, 8, 15, 22, 29, 36, 45, 52, 59 and 66) as well as an Assignment of Contracts pursuant to which the Debtor assigned to the Bank all of its right, title and interest in and to the Leases, together with "the equipment and the rent and payments provided therein . . ." ⁴ *See* ESB's Exhibits 2, 9, 16, 23, 30, 37, 46, 53, 60 and 67.

In an effort to perfect the security interests assigned to it pursuant to each Assignment of Contracts, the Bank filed UCC-1 financing statements ("UCC-1s") with the New York Department of State (the "Secretary of State") and the Onondaga County Clerk's Office in connection with each transaction. *See* ESB's Exhibits 5, 6, 12, 13, 19, 20, 26, 27, 33, 34, 40, 41, 49, 50, 56, 57, 63, 64, 70 and 71. Each UCC-1 purports to cover "[a]ll of debtor's right, title and

⁴ In connection with each transaction, the Debtor and the Bank entered into a "Servicing Agreement" pursuant to which the Debtor was to collect rental payments owing under the Leases from the lessees. *See* ESB's Exhibits 3, 10, 17, 24, 31, 38, 47, 54, 61 and 68. Upon collection, the Debtor was to pay all taxes, assessments and other charges levied or assessed against the Leases and equipment, and remit to the Bank all amounts due under each Promissory Note in accordance with the amortization schedules attached thereto.

Schedule A to each Assignment of Contracts identifies the assigned Leases by lease number, lessee, original term, remaining term and monthly payment. The Trustee asserts that the amount of the monthly payments identified on Schedule A to each Assignment of Contracts (the "Schedule A Payments") is equal to the monthly payments due under each Promissory Note, and does not include amounts earmarked for taxes and other assessments. The Trustee therefore disputes the Bank's contention that its security interest in the lease payments extends to all amounts collected under each Lease, and argues that the Bank's security interest secures only the Schedule A Payments. As has been previously indicated in connection with other bank motions in this case, the Court shall treat the Bank's Motion for Relief as seeking relief to enforce its security interest in the lease payments only to the extent of the outstanding Schedule A Payments. Without prejudice to either party, the Court will not at this time render a decision with respect to that portion of each Lease Payment in which the Bank's security interest is disputed, nor with respect to the leased equipment in which the Bank claims a perfected security interest.

interest in and to the contracts set forth in Schedule 'A' hereto annexed, and all substitutions and replacements thereto and all proceeds from the same exchange, collection or disposition thereof." Each UCC-1 filed by the Bank identifies the "debtor" as "Aloha Leasing, A Div. of The Bennett Funding Group, Inc."

The Bank now seeks relief from the automatic stay to obtain, *inter alia*, the Schedule A Payments (hereinafter sometimes referred to as the "Lease Payments") which have been collected and held by the Trustee, and to obtain future Lease Payments directly from lessees. The Bank maintains that it is entitled to relief under Code § 362(d)(1) because its interest in the Leases/Lease Payments is not adequately protected, and further, that it is entitled to relief under Code § 362(d)(2) because there is no equity in the Leases/Lease Payments and the Leases/Lease Payments are not necessary to an effective reorganization. *See* 11 U.S.C. §§ 362(d)(1) and (d)(2).⁵ The Trustee and the Official Committee of Unsecured Creditors appointed in these cases (the "Committee") dispute both of these contentions, but more significantly, argue that the Bank is not entitled to relief because it has not perfected its security interest in the Leases/Lease Payments because, *inter alia*, the UCC-1s were filed in the name of "Aloha Leasing, a Div. of

⁵ The Trustee points out that, in its Motion for Relief, the Bank seeks only to obtain future Lease Payments directly from lessees based upon a lack of adequate protection, pursuant to Code § 362(d)(1). Through the evidentiary declarations of Robert J. Colalella and Todd F. Palkovich, the Bank asserted a cause of action based upon Code § 362(d)(2) and requested relief to obtain Lease Payments collected by the Trustee and to set off \$20,051.58 on deposit in certain advance payment accounts maintained by the Debtor at the Bank. The Trustee objected to what he termed "the impropriety of seeking additional relief in the Bank's evidentiary declarations." *See* Trustee's Trial Memorandum of Law in Further Opposition to the Motion for Relief From the Automatic Stay by ESB Bank, F.S.B., filed April 22, 1997 (hereinafter the "Trustee's Trial Memorandum") at p. 4, n.6. Thus, at the hearing, the Bank made an oral motion to amend the pleadings to conform to the evidence pursuant to Fed.R.Bankr.P. 7015, which the Court granted over the Trustee's objection.

the Bennett Funding Group, Inc.," rather than in the name of "The Bennett Funding Group, Inc."⁶

The Trustee further argues that, even if the Bank is found to have a perfected security interest in the Lease Payments, the Court should use its discretionary power to limit the scope of the Bank's security interest pursuant to Code § 552, based upon the "equities of the case." *See* 11 U.S.C. § 552(b). The Trustee asserts that this is warranted because 1) the Bank failed to act in a reasonably prudent manner in monitoring the activities of the Debtor, and 2) the Debtor's estate has incurred costs in collecting Lease Payments for the benefit of the Bank which should be reimbursed.

DISCUSSION

Code § 362(e) requires an expedited hearing on a motion to lift the stay in the absence of compelling circumstances requiring that the time for the hearing be extended. *See* 11 U.S.C. § 362(e). At the same time, "[i]n reorganization cases, the stay is particularly important in maintaining the status quo and permitting the debtor in possession or trustee to attempt to formulate a plan of reorganization." 3 COLLIER ON BANKRUPTCY ¶362.03[2] at 362-14 (Lawrence P. King, 15th ed. 1997). The Bank's Motion for Relief was filed approximately one month after commencement of the Debtor's case. The Court granted interim relief on May 22,

⁶ The Committee filed a pre-trial memorandum of law on April 22, 1997. The objections of the Committee and the Trustee to the Motion for Relief are substantially the same, and, except to the extent specifically discussed herein, the Committee does not raise any objections not also substantially raised by the Trustee. *See generally* Memorandum of Law Submitted by the Official Committee of Unsecured Creditors in Opposition to the Motion Filed by ESB Bank, F.S.B. for Relief From the Automatic Stay, filed April 22, 1997.

1996 in order to allow the Trustee an opportunity to establish some order from the initial chaos. This included the employment of Coopers & Lybrand, L.L.P. to perform forensic accounting work and to assist in the stabilization of the Debtor's operations. In the Court's view, to have granted any of the Motions in a piecemeal fashion early on in this case would have caused further disruption to the Debtor's operations to the detriment of all of the thousands of the Debtor's creditors. Based on the information elicited at the various status conferences and the testimony of the Trustee at the Hearing, it is clear to the Court that the situation has now stabilized to the point where it is appropriate to dispose of the Bank's Motion for Relief.

I. Perfection of Security Interests

A creditor is generally not entitled to relief from the automatic stay unless it can establish that it possesses a perfected security interest in the property in question. *See, e.g., In re Hunt's Pier Assocs.*, 143 B.R. 36, 50 (Bankr. E.D.Pa. 1992).⁷ The Bank asserts that it has a perfected

⁷ The Bank appears to be domiciled in the Commonwealth of Pennsylvania, while the Debtor appears to be a New York corporation, thus raising an issue as to which state's law is to be applied in determining the extent of the Bank's security interest in the Leases/Lease Payments. Some courts, following *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487, 61 S.Ct. 1020, 85 L.Ed. 1477 (1941), hold that, in the absence of a compelling federal question, a bankruptcy court must apply the choice of law rules of its forum state. *See, e.g., Compliance Marine, Inc. v. Campbell (In re Merritt Dredging Co., Inc.)*, 839 F.2d 203 (4th Cir. 1988), *cert. denied*, 487 U.S. 1236, , 108 S.Ct. 2904, 101 L.Ed.2d 936 (1988). Other courts hold that a bankruptcy court must apply federal common law choice of law rules. *See, e.g., Lindsay v. Beneficial Reinsur. Co. (In re Lindsay)*, 59 F.3d 942, 948 (9th Cir. 1996), *cert. denied*, 116 S.Ct. 778, 133 L.Ed.2d 730 (1996); *Limor v. Weinstein & Sutton (In re SMEC, Inc.)*, 160 B.R. 86 (M.D.Tenn. 1993). The federal and New York choice of law rules each require application of the law of the jurisdiction having the greatest interest in the litigation. *See Koreag, Controle et Revision S.A. v. Refco F/X Assoc., Inc. (In re Koreag, Controle et Revision S.A.)*, 961 F.2d 341, 350 (2d Cir. 1992). The Court need not decide which of the aforementioned tests is appropriate because, under either test, New York law would apply to questions of perfection. New York has a more significant interest in this litigation than does Pennsylvania, given the fact that the Debtor is located in New York,

security interest in the Leases and in the Lease Payments, which, as the Court indicated in the October Decision, are two separate types of collateral. *See In re Bennett Funding Group, Inc.*, 203 B.R. at 38.⁸ The parties do not appear to dispute that the Leases constitute chattel paper, which is generally defined as a writing or group of writings which evidence both a monetary obligation and a security interest in specific goods.⁹ *See* NYUCC § 9-105(b); *see also, e.g., National Westminster Bancorp v. ICS Cybernetics, Inc. (In re ICS Cybernetics, Inc.)*, 123 B.R. 467, 475-76 (Bankr. N.D.N.Y. 1989) (finding equipment leases to be chattel paper).

NYUCC § 9-203(1) provides that a "security interest is not enforceable against the debtor or third parties . . . and does not attach unless: (a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral . . . ; (b) value has been given; and (c) the debtor has rights in the collateral." NYUCC § 9-203(3). At the Hearing, the Bank produced ink-signed originals

the UCC-1s were filed in New York and New York's policies of ensuring predictability in commercial transactions and providing notice to potential creditors are at issue. *See generally Hong Kong & Shanghai Banking Corp. v. HFH USA Corp.*, 805 F.Supp. 133, 140 n.3 (W.D.N.Y. 1992). Pursuant to § 1-105(2) of the New York Uniform Commercial Code ("NYUCC"), NYUCC § 9-103 governs choice of law questions relating to perfection of security interests in multiple state transactions. *See* NYUCC § 1-105(2).

⁸ In the October Decision, the Court set forth certain criteria with respect to perfection of a security interest in the Leases. For purposes of this decision, the Court will assume the reader's familiarity with the October Decision.

⁹ The Court notes that, in his Particularized Response, the Trustee generally disputed that the Leases were chattel paper because the Bank had apparently not produced copies of any of the Leases for his review. As discussed below, the Bank produced originals of all the Leases except Lease number 93080637, which appears to have been assigned pursuant to an Assignment of Contracts dated October 1, 1993. The Trustee has had an opportunity to review the Leases produced by the Bank at the Hearing, and since then has not made any specific argument that any of the Leases do not constitute chattel paper. Both the Bank and the Committee maintain that the Leases are chattel paper.

of all of the Leases, with the exception of a single lease, and all of the Assignments of Contracts.

The Bank also produced the Promissory Notes executed in connection with each transaction, indicating that value was given by the Bank. The parties do not appear to dispute that the Debtor had rights as lessor under the Leases at the time of the respective assignments. Therefore, the Bank has established that, with the exception of Lease number 93080637, its security interest in the Leases has attached.¹⁰ Hereinafter, the term "Leases" shall be deemed to exclude Lease number 93080637.

A. Perfection in the Leases

1. *Perfection by Filing*

A security interest in chattel paper may be perfected either by filing a financing statement, *see* NYUCC § 9-304,¹¹ or by the secured party's taking possession of the chattel paper, *see* 13 Pa.

¹⁰ Pursuant to the Servicing Agreements, the Debtor was required to "substitute a new [Lease] for, or pay all principal and interest due on, any defaulted or prepaid [Lease]." The Committee argues that the Bank has not established that its security interest attached in any of the leases which were so substituted in this case (the "Substituted Leases") because none of the Substituted Leases are specifically described on any Assignment of Contracts. This position is untenable because UCC § 9-203(1)(a) requires a secured party to show either that the debtor has signed a security agreement which contains a description of the collateral *or* that the security party possesses the collateral. *See* Official Comment to UCC § 9-203 (stating that "[s]ubsection (1)(a), therefore, dispenses with the written agreement - and thus with the signature and description - if the collateral is in the secured party's possession."). At the Hearing, the Bank produced the ink-signed original Substituted Leases, thereby establishing a perfected security interest in them.

¹¹ In a multistate transaction involving a *non-possessory* security interest in chattel paper, or a security interest in accounts, the law of the state where the debtor is located governs, which in this case is New York. *See* NYUCC §§ 9-103(4) and 9-103(3)(b).

Cons. Stat. Ann. § 9305 (West 1997);¹² *see also In re Keneco Financial Group*, 131 B.R. 90, 96 (Bankr. N.D.Ill. 1991). The evidence in the record indicates that BFG has a place of business in New York only in Onondaga County. Thus, if the Bank is to establish that it has a perfected security interest in the Leases by filing, it must show that it filed proper UCC-1s in both the Onondaga County Clerk's Office and the Secretary of State's Office. *See* NYUCC § 9-401(c); *John Deere Co. v. Pahl Constr. Co.*, 34 A.D.2d 85, 86, 310 N.Y.S.2d 945, 946 (4th Dep't 1970). The Trustee asserts that the Bank has not perfected its security interest in the Leases because each of the UCC-1s filed in Onondaga County identify the "debtor" as "Aloha Leasing, a Div. of Bennett Funding Group, Inc." rather than as "The Bennett Funding Group, Inc." Although the UCC-1s filed with the Secretary of State also identify BFG in this fashion, the Trustee focuses exclusively on the validity of the UCC-1s filed in Onondaga County, arguing that, as a result of the indexing system utilized by the Onondaga County Clerk, the UCC-1s do not sufficiently apprise the public of the Bank's security interest.

In the October Decision, the Court included a lengthy discussion concerning whether a financing statement identifying BFG by its trade name "Aloha Leasing" and its corporate name "The Bennett Funding Group, Inc." was effective to perfect a security interest in the leases. The Court commented that "[w]hether the trade name precedes or follows the legal name of the debtor should not make a difference, particularly in this age of computer indexing." *In re Bennett*

¹² In a multistate transaction, perfection of a *possessory* security interest in chattel paper is "governed by the law of the jurisdiction where the collateral is when the last event occurs on which is based the assertion that the security interest is perfected." *See* NYUCC § 9-103(3) and 9-103(1)(b). Thus, the Pennsylvania Commercial Code, 13 Pa. Cons. Stat. Ann. §§ 1101-9507 ("PAUCC"), governs with respect to the Bank's assertion that it perfected its security interest in the Leases by possession because it appears that, on the date of filing, the Bank possessed the original Leases in its offices located in Pittsburgh, Pennsylvania.

Funding Group, Inc., 203 B.R. at 37. The Court reasoned that if a search was performed under the name "Bennett Funding Group, Inc.," the computer would generate a list of those UCC-1s filed under the name of "Aloha Leasing, a Division of Bennett Funding Group, Inc.," because both the corporate name and the trade name should have been indexed as a single entry. In rendering its decision, however, the Court did not have the benefit of the testimony provided at the subsequent evidentiary hearing to the effect that the computer system utilized by the Onondaga County Clerk's Office did not permit a full search of the text as it appeared in the "debtor" box on the financing statement. Instead, the indexing is purely alphabetical and requires exact spelling. A search of UCC-1s filed in the name of "Bennett Funding Group, Inc.," will yield a list of only those financing statements which correctly spell, letter by letter, "Bennett Funding Group, Inc." *See* Declaration of Jacqueline A. Dacey, admitted as Trustee's exhibit Dacey I, at exhibit Dacey H attached thereto. If one wished BFG's name to be cross-indexed so that it would appear on a list of debtors whose names begin with the letter "A," it was necessary to pay an additional fee. No evidence was provided to the Court that a fee was paid to have the Bank's financing statements cross-indexed under both "Bennett Funding Group, Inc." and "Aloha Leasing."

It is now clear to the Court that a reasonably diligent search of the corporate name of BFG would not have revealed the Bank's UCC-1s filed in the name of "Aloha Leasing, a Div. of the Bennett Funding Group, Inc." There has been no suggestion that this was the result of an error by the filing officer in the indexing of the UCC-1s, nor has there been any suggestion that BFG conducted business solely under its trade name. In fact, all of the transactional documents offered by the Bank, including the promissory notes and Assignments of Contracts, identify BFG

by its legal name, The Bennett Funding Group, Inc.

In the October Decision, the Court suggested that a diligent creditor would have reviewed the Leases themselves and would have discovered reference to Aloha Leasing, thereby placing on the creditor a requirement that additional inquiry be made under the name "Aloha Leasing." *See In re Bennett Funding Group, Inc.*, 203 B.R. at 37-38. However, the Trustee presented evidence of an "investor package" allegedly sent to Eugene J. Manfra of Wayne, New Jersey on August 18, 1994, in connection with which Mr. Manfra was allegedly assigned an interest in Lease number 93090173, which was already included in one of the Bank's portfolios. *See* Declaration of Paul B. Szlosek, admitted as Trustee's exhibit Szlosek D, at ¶¶ 6-8. The documents comprising this investor package consisted of a sale invoice, statement of purchased contracts and assignment of contract, none of which mention Aloha Leasing. There is no reason to believe that Mr. Manfra would have conducted a search in any name but that of The Bennett Funding Group, Inc. Additionally, as a hypothetical lien creditor, a trustee is deemed to have no knowledge regarding a debtor's use of a trade name even though he may have actual notice as a result of his involvement in the management and operation of the debtor. *See Northern Comm'l Corp. v. Friedman (In re Leichter)*, 471 F.2d 785, 787 (2d Cir. 1972).

Therefore, having been presented with evidence of the actual indexing system utilized by the Onondaga County Clerk's Office, the Court finds that the assumptions it relied upon in rendering its October Decision, which were based in large part on the arguments of the banks' counsel, were incorrect at least with respect to the filing system in the county in which BFG does business in this State. If Onondaga County utilized a system which permitted a search of the full text of BFG's name, the Court's prior conclusions with respect to the inclusion of the BFG's trade

name would have had merit. Confronted with the actual operative facts, the Court must reconsider its position. Accordingly, the Court concludes that the UCC-1s filed by the Bank in the Onondaga County Clerk's Office under the name of "Aloha Leasing, a Div. of the Bennett Funding Group, Inc." were ineffective in that they failed to provide a creditor with notice sufficient to warrant further inquiry concerning the Leases. *See Dietrich-Post Co. of Washington Inc. v. Alaska Nat'l Bank of the North (In re McCauley's Reprographics, Inc.)*, 638 F.2d 117, 119 (9th Cir. 1981) (stating that "[w]hen the name of the debtor has been erroneously listed on the financing statement, the dispositive question is usually whether or not a reasonable search under the debtor's true name would uncover the filing."). A reasonable search for financing statements filed in the name of "Bennett Funding Group, Inc." would not have revealed financing statements filed under the name of "Aloha Leasing, a Div. of the Bennett Funding Group, Inc." Because the Bank did not file any proper UCC-1s in Onondaga County, it failed to perfect its security interest in the Leases by filing.

2. Perfection by Possession

As noted above, a security interest in chattel paper also may be perfected by the secured party taking possession of the collateral. In this case, the Bank has provided evidence that it is in possession of the ink-signed original Leases and, therefore, it has perfected its security interest in the Leases pursuant to PAUCC § 9305. *See id.*

B. Perfection in Lease Payments

The Lease Payments are "proceeds" of the Leases within the meaning of NYUCC § 9-

306.¹³ See NYUCC § 9-306; see also *In re Funding Systems Asset Management Corp.*, 111 B.R. 500, 519 (Bankr. W.D.Pa. 1990) (citing *Feldman v. Philadelphia Nat'l Bank*, 408 F.Supp. 24, 37 (E.D.Pa. 1976) (rental payments under an equipment lease were proceeds of chattel paper). Perfection of a security interest in cash proceeds is governed by NYUCC § 9-306(3). Generally, in order to maintain perfection of a security interest in proceeds, a properly filed financing statement must cover the original collateral or the security interest in proceeds must be separately perfected as if the proceeds were the original collateral. See NYUCC § 9-306(3). As discussed above, the Bank failed to file proper financing statements in this case.

The Bank, however, has argued generally throughout these cases that its security interest in the Lease Payments became automatically perfected when it took possession of the Leases. See generally Bank's Trial Brief, p. 22-25. In support of this argument the Bank cites *In re Commercial Management Service, Inc.*, 127 B.R. 296 (Bankr. D.Mass. 1991). There, the court held that a right to payment under an equipment lease is property which can be perfected by possession of the underlying chattel paper because "the necessary implication of [UCC] Section 9-305 is that delivery of chattel paper operates to transfer the *claim* that the paper represents" *Id.* at 302 (quoting Amelia H. Boss, *Lease Chattel Paper: Unitary Treatment of a "Special"*

¹³ NYUCC § 9-103 makes no reference to the law applicable in a multistate transaction to perfection of a security interest in cash proceeds. It appears that under either a federal, interest based choice of law analysis, or New York choice of law rules, New York would have the dominant interest in having its law be determinative of the Bank's interest in any Lease Payments, because the Lease Payments would appear to be located in New York. Cf. *Kunstsammlungen Zu Weimar v. Elicofon*, 536 F.Supp. 829, 846 (E.D.N.Y. 1981) (quoting comment a to § 246 of the Restatement (Second) of Conflict of Laws (1971) for the proposition that "[t]he state where a chattel is situated has the dominant interest in determining the circumstances under which an interest in the chattel will be transferred . . ."), *aff'd*, 678 F.2d 1150 (2d Cir. 1982); *In re Scott's Estate*, 129 Misc. 625, 222 N.Y.S. 515 (1927) (and cases cited therein) (dealing generally with the situs of cash deposits and the rights thereto for taxation purposes).

Kind of Commercial Specialty, 1983 Duke L.J. 69, 92-93 (1983) (emphasis added)). In citing *In re Commercial Management Service, Inc.* the Bank incorrectly equates a right to receive the Lease Payments with the Lease Payments themselves. "A contractual right to obtain money at some future time is not the same thing as money itself." *Vienna Park Properties v. United Postal Savings Ass'n (In re Vienna Park Properties)*, 976 F.2d 106, 116 (2d Cir. 1992). The *Commercial Management Service* case does not expressly address perfection in proceeds, which is governed by NYUCC § 9-306(3).

The Bank also relies generally upon the statement of the court in *Keneco Financial Group, Inc.* that "[i]n accordance with § 9-306(3) of the Uniform Commercial Code, Courts have consistently found that if a creditor has a perfected security interest in a lease, then the 'rent' generated by that lease constitutes 'proceeds' in which the creditor also has a perfected security interest." 131 B.R. at 94 (citations omitted); *see also In re Funding Systems Asset Management Group*, 111 B.R. 500, 520 (Bankr. W.D.Pa. 1990). Thus, the Bank appears to argue that it has a perfected security interest of indefinite duration in the Lease Payments simply by virtue of having taken possession of the Leases. It is true that, pursuant to NYUCC § 9-306(3), perfection in original collateral results in perfection in proceeds - but, as more fully explained below, perfection in the proceeds lasts only for ten days after the proceeds are received by the debtor unless certain additional steps are, or have been, taken to perfect in the proceeds. *See* NYUCC § 9-306(3). One such step is to file proper UCC-1s covering the original collateral, *see* NYUCC § 9-306(3)(b), which the Bank failed to do. The Bank does not expressly argue that it took any other steps under NYUCC § 9-306(3) to perfect its security interests in the Lease Payments beyond ten days after the Debtor's receipt thereof.

However, prior to the October Decision, it was suggested by at least one of the banks that, in the event that the Court were to conclude that it had not perfected its security interest in leases by filing effective financing statements, it nevertheless perfected its security interest in the lease proceeds beyond the ten day period referred to in NYUCC § 9-306(3) by taking constructive possession of such proceeds pursuant to Code § 546(b). *See* Memorandum of Law filed by Etowah Bank Group on September 9, 1996. The Court declined to address this argument in the October Decision because the majority of the banks had asserted that they had filed proper financing statements. *See In re Bennett Funding Group, Inc.*, 203 B.R. at 39 (stating that "at this juncture in the case the Court determines that it would not be in the parties' best interest to attempt to analyze the alternative scenario since it would only serve to unnecessarily delay the issuance of the Court's decision."; *see also id.* at 42 n.* (indicating that "the Court reserves the right to address this form of perfection if necessary in a subsequent decision . . . "

Furthermore, although the Bank has not raised the Code § 546(b) issue, the Court cannot ignore the impact of Code § 546 on the Bank's Motion in view of the fact that the Court undertook a comprehensive analysis of this issue in rendering the Reconsideration Decision. The Court will therefore incorporate that analysis into this decision, and, for clarity, will also include the arguments which were made by the Trustee and Marine. *Cf. Gins v. Mauser Plumbing Supply Co.*, 148 F.2d 974, 976 (2d Cir. 1945) (stating that "particular legal theories of counsel yield to the court's duty to grant the relief to which the prevailing party is entitled, whether demanded or not").

1. *Code § 546(b)*

Section 552(a) of the Code generally provides that property acquired by a debtor postpetition is not subject to a lien created by a security agreement entered into pre-petition. *See* 11 U.S.C. § 552(a). Exceptions to the general rule contained in Code § 552(a) are found in § 552(b). Relevant to the instant case is § 552(b)(1), which validates a postpetition security interest in, *inter alia*, proceeds, if the security agreement entered into pre-petition extends to proceeds. Code § 552(a) generally does not affect a creditor's right to claim an interest in property acquired by the debtor postpetition to the extent that such property can be regarded as "proceeds" of the creditor's collateral. *See, e.g., Unsecured Creditors Committee v. Marepcon Financial Corp. (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 1436 (4th Cir. 1990). However, if the security interest in proceeds is unperfected as of commencement of the case, it may potentially be avoided by the trustee pursuant to Code § 544. *See* 11 U.S.C. §§ 544, 552(b)(1).

The automatic stay generally prohibits "any act to create, perfect, or enforce any lien against property of the estate." 11 U.S.C. § 362(a)(4). Code § 362(b)(3) creates an exception to the automatic stay and allows "any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under § 546(b) of this title." 11 U.S.C. § 362(b)(3). Code § 546(b) allows "any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under § 546(b) of this title." 11 U.S.C. § 546(b). Section 546(b) of the Code provides:

(b)(1) The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that---

(A) permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection;
or

(B) provides for the maintenance or continuation of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation.

(2) If--

(A) a law described in paragraph (1) requires seizure of such property or commencement of an action to accomplish such perfection, or maintenance or continuation of perfection of an interest in property; and

(B) such property has not been seized or such an action has not been commenced before the date of the filing of the petition;

such interest in such property shall be perfected, or perfection of such interest shall be maintained or continued, by giving notice within the time fixed by such law for such seizure or such commencement.

11 U.S.C. § 546(b).

Section 546(b) "allows creditors with certain types of liens to avoid the potential prejudice of section 362's automatic stay by allowing for post-bankruptcy-petition perfection of these liens." *Miner Corp. v. Hunters Run Ltd. Partnership (In re Hunters Run Ltd. Partnership)*, 875 F.2d 1425, 1428 (9th Cir. 1989) (citing *In re Electric City, Inc.*, 43 B.R. 336, 340 (Bankr. W.D.Wash. 1984)). Essentially, Code § 546(b) "establish[es] an exception to the bar of the automatic stay where a creditor has a pre-petition interest in property that can be perfected under state law within a given time." *Makoroff v. City of Lockport*, 916 F.2d 890, 892 (3rd Cir. 1990), *cert. denied*, 499 U.S. 983, 111 S.Ct. 1640, 113 L. Ed. 2d 735 (1991).

The legislative history of Code § 546(b) explains in part:

[I]f an interest holder against whom the trustee would have rights still has, under applicable nonbankruptcy law, and as of the date of the petition, the opportunity to perfect his lien against an intervening interest holder, then he may perfect his interest against the trustee. If applicable law requires seizure for perfection, then perfection is by notice to the trustee instead. The rights granted to a creditor

under this subsection prevail over the trustee only if the transferee has perfected the transfer in accordance with applicable law, and that perfection relates back to a date that is before commencement of the case . . . The purpose of the subsection is to protect, in spite of the surprise intervention of [the] bankruptcy petition, those whom state law protects by allowing them to perfect their liens or interests as of an effective date that is earlier than the date of perfection.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 371 (1977); S. Rep. No. 95-989, 95th Cong., 2nd Sess. (1978), U.S. Code Cong. & Admin. News 1978, p. 5787.

In arguing for reconsideration of the Court's decision on Marine's Code § 362(d) motion, Marine maintained that "applicable law" within the meaning of Code § 546(b) includes NYUCC § 9-306, which, in the absence of bankruptcy, would allow the Bank to perfect its interest in certain of the lease proceeds through possession.¹⁴ Marine asserted that because it would have been allowed to perfect its security interest in lease payments by seizure under state law, Code § 546(b) allowed it to perfect its interest in lease payments postpetition by giving notice to the Trustee. Marine contended that the filing of its Code § 362(d) motion constituted the notice contemplated by Code § 546(b).

As noted above, perfection of a security interest in proceeds is governed by NYUCC § 9-306(3), which provides:

The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless

¹⁴ Pursuant to Code § 546(b)(2), if applicable law requires seizure or commencement of an action to accomplish perfection or maintenance of perfection, then perfection shall be by notice instead. The Trustee argued that NYUCC § 9-306 does not "require" seizure because that statute permits perfection either by seizure or by filing, and, therefore, that notice cannot be used to maintain perfection of a security interest in lease payments. The Court rejected this argument. NYUCC § 9-305, as incorporated by NYUCC § 9-306(3)(c), clearly requires seizure.

(a) a filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected in the office or offices where the financing statement has been filed . . .; or

(b) a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or

(c) the security interest in the proceeds is perfected before the expiration of the ten day period.

Except as provided in this section, a security interest in proceeds can be perfected only by the methods or under the circumstances permitted in this chapter for original collateral of the same type.

NYUCC § 9-306(3).

In the Reconsideration Decision, the Court found that, because Marine had not perfected its security interest in leases or lease payments by filing, it could perfect its security interest in lease payments beyond the ten day period referred to in NYUCC § 9-306(3), if at all, only pursuant to NYUCC § 9-306(3)(c). It is undisputed that the Lease Payments are cash proceeds in the form of money, an interest in which can be perfected only in the manner and under the circumstances that a security interest in money as original collateral would be perfected. With certain exceptions not applicable here, a security interest in money can be perfected only by possession, *see* NYUCC §§ 9-304(1), 9-305.

The Trustee asserted that NYUCC § 9-306 is not “applicable law” within the meaning of Code § 546(b). The Trustee steadfastly maintained that Code § 546(b) can only be used in conjunction with a law which allows perfection to relate back to a time prepetition, and that NYUCC § 9-306 is not such a law. Marine took the position that Code § 546(b) does not contain a relation-back requirement, and that even if it did, NYUCC § 9-306(3) unambiguously indicates that the security interest in proceeds is a continuously perfected security interest from the time

the security interest in the original collateral is perfected. Marine asserted that it had a perfected security interest in the lease proceeds dating from the time it perfected its security interest in the leases by possession of the originals, which occurred prepetition.

The Trustee countered by citing NYUCC § 9-305, which provides in pertinent part that "[a] security interest is perfected by possession from the time possession is taken *without a relation back* and continues only so long as possession is retained, unless otherwise specified in this Article." NYUCC § 9-305 (emphasis added). The Trustee effectively argued that a security interest in proceeds which is perfected by possession can only be continuously perfected from the date of possession by the debtor and not from the date the security interest in the original collateral was perfected. Marine responded by asserting that there are exceptions to the general prohibition against relation back of possessory security interests, as indicated by the "unless otherwise specified by this Article" language of NYUCC § 9-305, and that one such exception obtains when perfection of an interest in proceeds is accomplished by possession pursuant to NYUCC § 9-306(3)(c). To this, the Trustee pointed to Official Comment 3 to NYUCC § 9-305, which provides in pertinent part:

This section now brings state law into conformity with the overriding federal policy: where a pledge transaction is contemplated, perfection dates only from the time possession is taken . . . The *only* exception to this rule is the short twenty-one day period of perfection provided in Section 9-304(4) and (5) during which a debtor may have possession of specified collateral in which there is a perfected security interest.

See Official Comment 3 to NYUCC § 9-305 (emphasis added).

The Court found that it did not need to address the question of whether NYUCC § 9-306 allows for perfection to relate back. For the reasons set forth herein, resolution of that issue is not necessary in order to determine whether the Trustee is able to avoid the Bank's security

interest in the Lease Payments.

Code § 546(b) has not been uniformly interpreted by the courts. A majority of the caselaw surrounding Code § 546(b) appears to indicate that §546(b) can only be invoked to effect perfection or the maintenance or continuation of perfection of an interest in property obtained prepetition if such perfection relates back to a time prepetition. Some cases expressly state as much. *See Casbeer v. State Federal Savings & Loan Ass'n of Lubbock (In re Casbeer)*, 793 F.2d 1436, 1443 (5th Cir. 1986); *In re Westport-Sandpiper Assocs.*, 116 B.R. 355, 358 (Bankr. D.Conn. 1990); *Drummond v. Farm Credit Bank of Spokane (In re Kurth Ranch)*, 110 B.R. 501, 507 (Bankr. D.Mont. 1990); *Northwestern Nat'l Life Ins. Co. v. Metro Square (In re Metro Square)*, 93 B.R. 990, 999 (Bankr. D.Minn. 1988), *rev'd on other grounds*, 106 B.R. 584 (D.Minn. 1989); *In re TM Carlton House Partners, Ltd.*, 91 B.R. 349, 356 (Bankr. E.D.Pa. 1988); *In re Association Center Ltd. Partnership*, 87 B.R. 142, 146 (Bankr. W.D.Wash. 1988), *In re Pritchard Plaza Assocs. Ltd. Partnership*, 84 B.R. 289, 301 (Bankr. D.Mass. 1988), *Turner v. Emmons & Wilson, Inc. (In re Minton Group, Inc.)*, 28 B.R. 789, 792 (Bankr. S.D.N.Y. 1983). Some of the cases expressly holding that Code § 546(b) requires "relation back" are based, at least in part, upon other caselaw which might at first glance support such a conclusion, but which, when carefully read, do not indicate that "relation back" is required by Code § 546(b).

For example, the decision of the United States Court of Appeals for the Third Circuit in *Makoroff v. City of Lockport*, 916 F.2d at 890, has been cited as support for the "relation back" requirement. *See, e.g., Matter of Perona Bros., Inc.*, 186 B.R. 833, 837 (D.N.J. 1995). *Makoroff*, however, does not state that Code § 546(b) can only be utilized in conjunction with a "relation-back" statute. Rather, *Makoroff* appears to stand for, *inter alia*, the proposition that when §546(b)

is used to accomplish postpetition perfection pursuant to a "relation-back" statute, such perfection is not a violation of the automatic stay. *See also Equibank, N.A. v. Wheeling Pittsburgh Steel Corp.*, 884 F.2d 80, 85 (3rd Cir. 1989); *Yobe Electric, Inc. v. Graybar Electric Co, Inc. (In re Yobe Electric, Inc.)*, 728 F.2d 207 (3d Cir. 1984) (adopting bankruptcy judge's opinion at 30 B.R. 114 (Bankr. W.D.Pa. 1983)).

The decision of the United States Court of Appeals for the Second Circuit in *Lincoln Savings Bank, FSB v. Suffolk County Treasurer (In re Parr Meadows Racing Ass'n, Inc.)*, 880 F.2d 1540 (2d Cir. 1989), *cert. denied*, 493 U.S. 1058, 110 S.Ct. 869, 107 L.Ed.2d 953 (1990), has also been cited as support for the relation-back requirement. *See Town of Colchester v. Hinesburg Sand and Gravel, Inc. (In re APC Constr., Inc.)*, 112 B.R. 89, 112-13 (Bankr. D.Vt. 1990), *aff'd* 132 B.R. 690 (D.Vt. 1991). In *Parr Meadows*, the Suffolk County Treasurer attempted to utilize Code § 546(b) to perfect certain tax liens postpetition. There, the issue as it related to Code § 546(b) was not whether perfection of the tax liens related back to a prepetition date, but whether the Suffolk County Treasurer had obtained interests in the debtor's property prepetition which could be perfected postpetition. *See Parr Meadows*, 880 F.2d at 1546. The Second Circuit held that the automatic stay prohibited the creation and perfection of a tax lien against estate property unless Suffolk County had a prepetition interest in such property for a given tax year. *See id.* at 1548. The Second Circuit in *Parr Meadows* did not address whether perfection need relate back to a time prepetition, presumably because Suffolk County's valid tax liens primed competing interest holders as a matter of statute, without regard to date of perfection. In *Klein v. Civalo & Trovato, Inc. (In re Lionel Corp.)* 29 F.3d 88 (2d Cir. 1994), the Second Circuit again considered Code § 546(b). There, a creditor had performed construction

work on property leased by the bankruptcy debtor. The creditor had filed a notice of mechanic's lien against the property prepetition. The New York Lien Law required the creditor to serve notice of its mechanic's lien filing on the property owner within 30 days after filing. When the creditor attempted to serve such notice postpetition, the debtor and the owners argued that it violated the automatic stay. *See id.* at 90. The Second Circuit summarized the debtor's and the owners' arguments and stated:

Appellees claim that CTI cannot take advantage of . . . [§546(b)] absent a specific provision of law permitting the perfection to "relate-back" to an earlier time. Appellees argue that because CTI filed too late to take advantage of New York Lien Law's relation-back provision, CTI cannot be saved by § 546(b). This analysis was adopted by both the bankruptcy court and the district court. We take a different view.

We see nothing in § 546(b) indicating that it applies only when the lienor fits within a "relation-back" statute. As long as an "applicable law" authorizes perfection after another party has acquired interests in the property, a lienor fits within the exception.

Id. at 93.

The mechanic's lien creditor in *Lionel* was able to invoke Code § 546(b) because its lien prevailed over a hypothetical judicial lienor under state law, even in the absence of a relation-back statute. The Second Circuit observed that under the relevant provisions of the New York Lien Law,

CTI's lien was created at the time it filed its notice of lien and, as of that date, took priority over any subsequently filed interest. CTI achieved this superior status even before it complied with § 11's requirement that it serve its notice of lien and file proof of such service In other words, while complying with § 11 is necessary to keep a lien alive, it is not a prerequisite to establishing the lien's initial validity, and hence, priority.

Id.; accord *Vanderbilt Mortgage and Finance, Inc. v. Griggs (In re Griggs)*, 965 F.2d 54, 58 (6th Cir. 1992) (creditor's security interest prevailed over trustee because Code § 546(b) allowed

creditor to perfect security interest in mobile home postpetition by obtaining certificate of title containing notation of lien, and Kentucky statute provided that perfection dated from time financing statement had been filed prepetition).

This Court agrees with, and is in any event bound by, the Second Circuit's determination in *Lionel* that Code § 546(b) can allow for postpetition perfection in the absence of a "relation-back" statute. However, a distillation of caselaw, read in conjunction with the statute and its legislative history, leads the Court to conclude that in many, if not most, cases, a "relation-back" requirement is a *fait accompli* to the utility of Code § 546(b) because a creditor invoking § 546(b) must somehow be able to defeat the rights of an intervening hypothetical lien creditor under state law, whether through a relation-back statute or otherwise.

As one court has observed in rejecting a relation-back requirement under Code § 546(b), "the proper focus of § 546(b) is whether the entity invoking § 546(b) defeats the rights of a hypothetical entity that earlier acquires rights in the property in dispute." *First American Bank of Virginia/WNB Corp. v. Harbour Pointe Ltd. Partnership (In re Harbour Pointe Ltd. Partnership)*, 132 B.R. 501, 503-504 (Bankr. D.D.C.. 1991) (quoting *In re 1301 Connecticut Ave. Assocs.*, 117 B.R. 2, 10 (Bankr. D.D.C. 1990, *aff'd*, 126 B.R. 1 (D.D.C. 1991)); *see also In re Microfab, Inc.*, 105 B.R. 152, 158 (Bankr. D.Mass. 1989) (finding that Code §546(b) "applies to any lien . . . that has the effect of priming an earlier perfected interest in the property."); *In re 1350 Piccard Ltd. Partnership*, 148 B.R. 83, 85 (Bankr. D.D.C. 1992) (declining to adopt a relation-back requirement under Code §546(b)). *Compare In re Kearney Hotel Partners v. Richardson (In re Kearney Hotel Partners)*, 92 B.R. 95, 105 (Bankr. S.D.N.Y. 1988) (ultimately finding a relation-back requirement but admitting that "[t]he language of § 546(b) might facially

appear to permit perfection if priority over a lien creditor is thereby achieved.").

2. *Leases as Indispensable Embodiment of Right to Receive Lease Payments*

As noted above, in order for a security interest in proceeds of collateral to be continuously perfected, the security interest in the original collateral must be perfected. *See* NYUCC § 9-306(3). The Bank perfected its security interest in the Leases by possession prepetition. The assignment or transfer of a lease document also effects a transfer of, *inter alia*, the right to receive payment evidenced by the lease, on the theory that a lease is quasi-negotiable because, *inter alia*, it is the indispensable embodiment of the right to lease rentals. *See* Boss, *Lease Chattel Paper: Unitary Treatment of a "Special" Kind of Commercial Specialty*, 1983 Duke L.J. at 69. Thus, the court in *In re Commercial Management Serv., Inc.* held that a right to payment under an equipment lease is a right which can be perfected by possession of the underlying chattel paper. *See* 127 B.R. 296 (Bankr. D.Mass. 1991). The court in *Commercial Management Serv., Inc.*, quoting from Professor Boss' article, stated:

[t]aking possession of the collateral, the chattel paper itself, would be meaningless unless the paper represented the underlying rights which were transferred by a transfer of the paper. Therefore, the necessary implication of Section 9-305 is that delivery of chattel paper operates to transfer the claim that the paper represents . . .

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[S]ection 9-305 bestows on leases an important element of negotiability: a lease is treated as the embodiment of the rights it represents such that these rights are transferred by the transfer of the lease document.

Id. at 302 (quoting Boss at 92-94 and omitting footnotes); *see also* WILLIAM D. HAWKLAND, ET AL., UNIFORM COMMERCIAL CODE SERIES § 9-106:01(Clark, Boardman, Callaghan) (1997)

(stating that “[t]he Code drafters were careful to ensure that obligations evidenced by . . . chattel paper would be treated not as intangibles but as part of the . . . chattel paper”); Steven O. Weise, *U.C.C. Article 9 - Personal Property Secured Transactions*, 47 Bus.Law. 1593, 1609 (opining that *Commercial Management Service, Inc.* was correctly decided); compare *Talmadge v. United States Shipping Board, Emergency Fleet Corp.*, 54 F.2d 240, 243 (2d Cir. 1932) (stating “[b]ut the company, having assigned its interest in the cheques as security, it would defeat the purpose to exclude the purely ancillary right to collect in case of their dishonor. Hence it seems reasonable to hold that the two passed together.”).

Based upon the foregoing, the Bank obtained a perfected security interest in the right to receive future Lease Payments stemming from those Leases at the time it took possession of the Leases. Because this occurred prepetition, the Trustee cannot avoid the Bank's security interest in the right to receive those Lease Payments.¹⁵

3. Continuation of Perfected Security Interest in Lease Payments

Simultaneously with the conversion of a portion of each Lease into Lease Payments, there exists a perfected security interest in identifiable Lease Payments which continues for ten days. However, if no steps are taken to continue the perfection in the security interest in any identifiable Lease Payments, the security interest becomes unperfected ten days after receipt by

¹⁵ Pursuant to NYUCC § 9-306(2), the security interest in the Leases continues notwithstanding the conversion of the Leases into Lease Payments periodically. As one court has described the process, “the path from various forms of collateral to cash proceeds is a ‘continuous and uninterrupted metamorphosis, through which the security interest remains intact.’” See *In re Barkley*, 31 B.R. 924, 927 (Bankr. W.D.Mich. 1983) (quoting *Klinger v. Pocono Internat’l Raceway, Inc.*, 289 Pa. Super. 484, 433 A.2d 1357, 31 UCC Rep. 1223 (1981)).

the Debtor. *See* NYUCC § 9-306.

In order to continue its perfected security interest in the Lease Payments as they are received by the Debtor, the Bank must give proper notice under Code § 546(b). "Section 546(b) provides little guidance as to what constitutes the requisite notice." *In re Coated Sales, Inc.*, 147 B.R. 842, 846 (S.D.N.Y. 1992) (quoting *In re Sampson*, 57 B.R. 304, 309 (Bankr. E.D.Tenn. 1986)). One court has stated that "notice is sufficient if it informs the court or the possessor of the property that the creditor intends to enforce his lien." *In re Gelwicks*, 81 B.R. 445, 448 (Bankr.N.D.Ill. 1987). Another court has stated that appropriate notification can only occur if the notice is filed in the bankruptcy court. *See In re Coated Sales, Inc.*, 147 B.R. at 846 (citations omitted). Thus, the filing of a motion for relief from the automatic stay has been held to constitute sufficient notice under Code § 546(b). *See In re Casbeer*, 793 F.2d at 1442-43; *Federal Nat'l Mortgage Ass'n v. Dacon Bolingbrook Assocs. Ltd. Partnership (In re Federal Nat'l Mortgage Ass'n)*, 153 B.R. 204, 212-13 (N.D.Ill. 1993); *see also Virginia Beach Fed. Sav. and Loan Ass'n v. Wood (In re Wood)*, 901 F.2d 849, 853 (10th Cir. 1990) (filing of notice of claim to cash collateral sufficient §546(b) notice); *In re C.G. Chartier Constr., Inc.*, 126 B.R. 956, 959 (E.D.La. 1991) (finding motion for adequate protection filed in bankruptcy court sufficient to provide Code § 546(b) notice); *In re Coated Sales, Inc.*, 147 B.R. at 846 (concluding that filing of secured claim in bankruptcy court provided sufficient Code § 546 notice). *But see In re Village Properties, Ltd.*, 723 F.2d 441 (5th Cir. 1984), (indicating that motion for relief from stay was insufficient Code § 546(b) notice because there was no indication of intention to pursue rent payments), *cert. denied*, 466 U.S. 974, 104 S.Ct. 2350, 80 L.Ed.2d 823 (1984).

In the Reconsideration Decision, the Court concluded that Marine's Code § 362(d) motion

was sufficient notice under Code § 546(b) because it gave notice of Marine's intent to "pursue recovery of the Proceeds." *See* Reconsideration Decision at 46 (quoting Affidavit in Support of Marine's Motion to Modify the Automatic Stay). Upon review of the Bank's motion for relief, the Court finds similar language (*see* Motion for Relief at 26, seeking relief "to allow ESB Bank to arrange for the payments due under the leases to be made directly to ESB Bank") , and concludes that the Bank's Motion for Relief provided notice under Code §546(b) to the Debtor of the Bank's intent to enforce its security interest in the Lease Payments generated and/or received subsequent to the filing of the Motion for Relief. This notice was effective to take possession of any identifiable Lease Payments received by the Debtor within ten days prior to the date the Motion for Relief was filed on April 25, 1996, because the Lease Payments received during that period remained subject to the Bank's perfected security interest pursuant to NYUCC § 9-306(3).

In connection with the Reconsideration Decision, the Trustee argued that Code § 546(b) cannot be read to establish a federal rule of perfection or to give a creditor more protection than would exist under state law. The Trustee argued that notice given under Code § 546(b) cannot apply prospectively because such notice must be given "within the time fixed by [state] law for such seizure . . . ," and the time for seizure under state law cannot begin until lease payments exist. The Trustee cited *Parr Meadows*, 880 F.2d at 1547, for the proposition that Code § 546(b) cannot be exercised repeatedly during a bankruptcy case.

The Trustee's arguments might have merit if it were true, as a general statement of law, that Code § 546(b) cannot be applied more than once in a given case. In *Parr Meadows*, the Second Circuit stated:

[W]e question whether 546(b) was ever intended to apply repeatedly during a prolonged bankruptcy. Section 546(b) was enacted to aid the creditor the creditor who, "surprise[d] [by the] intervention of [the] bankruptcy petition", is prohibited by the automatic stay from perfecting its interest in the debtor's property, but who otherwise would still be permitted to perfect that interest under state law. The section was "not designed to give the States an opportunity to enact disguised priorities in the form of liens that apply only in bankruptcy cases."

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Instead of interpreting § 546(b) as a one-time exception for the creditor who gave value but has not yet perfected its lien, the county would have us create a rotating exception, which, every December 1, would add another lien at the front of the priority line, enabling the county to effectively collect on all its claims as if no bankruptcy petition had ever been filed. Such an interpretation would effectively remove the taxing arms of local government from the controlling provisions of the bankruptcy code, a result clearly contrary to the intent of congress.

Id. at 1547 (citations omitted).

In the foregoing passages from *Parr Meadows*, the Second Circuit questioned whether § 546(b) could be repeatedly used to effectively allow postpetition tax liens to be, not simply perfected, but also *created*. *See id.* In contrast, the Bank is here seeking to utilize Code § 546(b) not to create liens, but only to perfect existing liens on Lease Payments. In the absence of the automatic stay, the Bank would have been able to seize Lease Payments on an ongoing basis. The Second Circuit's statements in *Parr Meadows*, quoted above, are arguably *dicta* and, in any event, were made in a context which is not factually analogous to the present case. Clearly, Code § 546(b) is not by its text limited to a one-time invocation during a bankruptcy case.

With these considerations in mind, the Court concludes that the Bank's Motion for Relief served as notice for all Lease Payments generated and/or received subsequent to its filing. *See Jones v. Salem Nat'l Bank (In re Fullop)*, 6 F.3d 422, 431 (7th Cir. 1993) (citations omitted) (allowing bank's departure from prepetition routine of remitting to debtor excess installment

payments received from debtor's assignee to constitute Code § 546(b) notice to perfect lien on multiple, and apparently future, installment payments). To conclude otherwise would allow for the patent absurdity of the Bank repeatedly having to serve notices at least every ten days until all Lease Payments have been received.

The fact that the Bank provided the Debtor with notice of its intent to seize the Lease Payments is ineffective unless the Lease Payments are identifiable. *See* NYUCC §9-306(2). In the Reconsideration Decision, the Court found while lease payments were not rendered identifiable by virtue of the filing of Marine's Code § 362(d) motion, certain lease payments were identifiable as a result of having been segregated by the Trustee pursuant to a segregation order. The Trustee argued, however, that the segregation order could not serve to render lease payments identifiable because the segregation order was a product of bankruptcy and could not be construed to give the Bank any greater rights than would exist under state law. The Trustee asserted that certain of lease payments had been deposited into a "honeypot" of funds from various sources and, citing GILMORE, 2 SECURITY INTERESTS IN PERSONAL PROPERTY, §27.4 at 735-36 (1965), argued that once commingled in a debtor's bank account, proceeds lose their identifiability.

The Court found the Trustee's arguments concerning the identifiability of the Lease Payments unavailing. Likewise, those same arguments do not have any more force in the context of the instant Motion for Relief. First, the Trustee previously acknowledged that the Bank was seeking to collect the Lease Payments. *See* Trustee's Objection to ESB Bank's Motion for Relief from the Automatic Stay, filed July 15, 1996, at 20. Secondly, the Trustee acknowledged that he did not dispute "the satisfaction of the identifiable cash proceeds portion

of [§ 9-306(3)], which is satisfied by the Trustee's compliance with 11 U.S.C. § 363(c)(4) and the interim cash collateral orders entered by this Court." *See id.* Furthermore, the Segregation Order did not give the Bank any right which did not exist under state law, because, in the absence of bankruptcy, and upon default, the Bank had the right to require direct payments from the lessees to the Bank as a form of segregation. Presumably, the Bank also could have obtained a state court order of segregation.

Therefore, as the Court concluded earlier, mere filing of the Motion for Relief on April 25, 1996, functioned to give notice to the Debtor of the Bank's intent to seize the Lease Payments. Filing of the Motion for Relief did not, however, render the Lease Payments *identifiable*. To conclude otherwise, if, as the Trustee has suggested, the Lease Payments were previously commingled with other funds, might allow the Bank to obtain funds in which it did not have a perfected security interest to the prejudice of other parties in interest. Contrary to the Trustee's argument in reliance on Professor Gilmore's position, New York law provides that proceeds do not *ipso facto* lose their identifiability when commingled with other funds. As one New York court has stated,

The courts that have heretofore considered this issue have rejected the opinion of Professor Gilmore in that . . . [his] statement was made in 1965 prior to the 1972 amendment to section 9-306(1) which included deposit accounts within the definition of proceeds to which a security interest would continue and that [his] statement is against the spirit of section 9-205.

General Motors Acceptance Corp. v. Norstar Bank, N.A., 141 Misc.2d 349, 352, 532 N.Y.S.2d 685, 687 (citation and footnote omitted) (N.Y.Sup.Ct. 1988). Thus, the court in *General Motors Acceptance Corp. v. Norstar Bank, N.A.* ultimately concluded that, "under New York law, proceeds, as defined in section 9-306, are identifiable in spite of commingling when they can be

traced under principles of trust accounting," and indicated that the "lowest intermediate balance" method of accounting is appropriate to trace proceeds. *Id.* at 355, 689. In this case, however, the Bank failed to provide any evidence that Lease Payments received prior to May 22, 1996, the date the Court signed the Segregation Order, are identifiable. While the Trustee alleges that he has complied with Code § 363(c)(4) in segregating the Lease Payments, there was no evidence presented at the Hearing to indicate when that occurred. As noted above, the Trustee does not dispute that the Lease Payments became identifiable as a result of his compliance with the Segregation Order. Therefore, based upon the evidence before it, the Court finds that the Bank is entitled to Lease Payments received by the Trustee from May 22, 1996, going forward.

4. *Rights of the Trustee as a Judicial Lien Creditor under Code § 544*

None of the foregoing analysis directly answers the question of priority between the Bank and the Trustee as to the Lease Payments. Pursuant to NYUCC § 9-301(1)(b), an unperfected security interest is subordinate to the rights of a person who becomes a "lien creditor" before the security interest is perfected. The term "lien creditor" is defined by NYUCC § 9-301(3) to mean "a creditor who has acquired a lien *on the property involved* by attachment, levy or the like and includes . . . a trustee in bankruptcy from the date of the filing of the petition" (emphasis added). It remains to be seen whether a lien creditor could obtain a lien on future Lease Payments before the Bank's security interest therein becomes perfected.

The Trustee generally has the rights and powers of a lien creditor as of the Petition Date pursuant to Code § 544, which provides in pertinent part:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer

of property of the debtor or any obligation incurred by the debtor that is voidable by---

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists . . .

11 U.S.C. § 544(a)(1).

Pursuant to Code § 544(a)(1), the trustee has the rights and powers of a hypothetical creditor with a judicial lien on "all property on which a creditor on a simple contract could have obtained such a judicial lien" on the petition date. Thus, a bankruptcy trustee endowed with the "strong arm" powers of Code § 544 has been described as "'the ideal creditor, irreproachable and without notice, armed *cap-a-pie* with every right and power which is conferred by the law of the state upon its most favored creditor who has acquired a lien by legal or equitable proceedings,'" *see Havee v. Belk*, 775 F.2d 1209, 1218 n.15 (4th Cir. 1985) (quoting *In re Kravitz*, 278 F.2d 820, 822 (3rd Cir. 1960)), and as "the perfect litigant without flaw." *See Rinn v. First Union Nat'l Bank of Maryland*, 176 B.R. 401, 413 (D.Md. 1995) (quoting *In re Barnett*, 62 B.R. 638, 640 (Bankr. D.Md. 1986)).

As the court observed in *Rinn v. First Union Nat'l Bank of Maryland*,

[While] it is the federal law which provides the trustee with his "strong-arm" power, his exercise of such power and its extent are governed entirely by the applicable state law . . . [the strong-arm section] confers on the trustee no "greater rights than those accorded by the applicable [state] law to a creditor holding a lien by legal or equitable proceedings."

Havee v. Belk, 775 F.2d at 1218-19, quoting 4A COLLIER ON BANKRUPTCY, 604 (14th ed. 1976) (emphasis added); *accord Angeles Real Estate Co. v. Kerxton*, 737 F.2d 416, 418 (4th Cir. 1984) ("A trustee in bankruptcy stands in the shoes of the bankrupt and succeeds only to the bankrupt's interest in property [as a judgment lien creditor] . . . Thus, if under applicable state law a judgment lien creditor would prevail over an adverse claimant, the trustee in bankruptcy will prevail; if not, he will not."); *Eastern Shore Bldg. v. Bank of Somerset*, 253 Md.

525, 253 A.2d 367, 370 (1969) ("A judgment creditor ' (sic) stands in the place of his debtor, subject to the equitable charges to which it was liable in the hands of the debtor, at the time of the rendition of the judgment.")

Rinn, 176 B.R. at 412 n.14.

"Once the trustee has assumed the status of a hypothetical lien creditor under § 544(a)(1), state law is used to determine what the lien creditor's priorities and rights are." *See In re Kors, Inc.*, 819 F.2d 19, 22-23 (2d Cir. 1987) (citations omitted). It appears that under either a federal, interest based choice of law analysis, or New York choice of law rules, Pennsylvania would have the dominant interest in determining the Trustee's rights and powers under Code § 544(a)(1) with respect to obtaining a lien on the Debtor's right to receive the Lease Payments. *Cf. Kunstsammlungen Zu Weimar v. Elicofon*, 536 F.Supp. at 846 (quoting comment a to § 246 of the Restatement (Second) of Conflict of Laws (1971) for the proposition that "[t]he state where a chattel is situated has the dominant interest in determining the circumstances under which an interest in the chattel will be transferred . . ."); *see also Hassett v. Far West Fed. Sav. and Loan Ass'n (In re O.P.M. Leasing Services, Inc.)*, 40 B.R. 380, 399 (Bankr. S.D.N.Y. 1984) (suggesting that, as a general rule, New York applies law of situs of personal property in determining claims to such property) (citations omitted), *aff'd*, 44 B.R. 1023 (S.D.N.Y. 1984); *accord* 5 COLLIER ON BANKRUPTCY ¶ 544.02 at 544-5 (King, 15th ed. 1997) (stating that the trustee's rights under Code § 544(a) are "measured by the substantive law of the jurisdiction governing the property in question.") (citations omitted). *Compare Crichton v. McGehee*, 20 N.Y.2d 124, 228 N.E.2d 799, 281 N.Y.S.2d 811 (1967) (rights of New York domiciliary to intangible personal property of her deceased husband located in Louisiana were governed by New York law because New York had paramount interest in regulating the rights of married persons domiciled in New

York).

With respect to intangible property, the general rule has long been that the situs of such property follows the domicile of the owner. *See, e.g., In re Brown's Estate*, 274 N.Y. 10, 18, 8 N.E.2d 42, 44 (1937), *rev'd on other grounds sub nom. Graves v. Elliott*, 307 U.S. 383, 59 S.Ct. 913, 83 L.Ed.2d 1256 (1939). An exception to this rule exists for intangible property, such as a right to payment, which is embodied in a document such as a personal property lease. "Such documents and the personal property merged or embodied in them have, like tangible chattels, a situs apart from the domicile of the owners." *Hutchison v. Ross*, 262 N.Y. 381, 390, 187 N.E. 65, 69 (1933); *accord* Boss, *Lease Chattel Paper: Unitary Treatment of a "Special" Kind of Commercial Specialty*, 1983 Duke L.J. at 69. Because the Leases appear to be in Pennsylvania, the extent of the Trustee's hypothetical lien on the Debtor's right to receive Lease Payments must be determined under Pennsylvania law.

In Pennsylvania, a judgment creditor generally acquires a lien on intangible personal property by having the sheriff serve a writ of execution on a garnishee. *See* Pa.R.Civ.P. 3108(4); 3111(b). Service of the writ gives rise to a lien on all property capable of attachment under the Pennsylvania Rules of Civil Procedure. *See id.* 3111(b). Rule 3101(b) provides that "[a]ny person may be a garnishee and shall be deemed to have possession of the property of the defendant if he (1) owes a debt to the defendant [or] (2) has property of the defendant in his custody, possession or control." *Id.* 3101(b).

However, regardless of what property is subject to attachment, the law does not allow a lien creditor to obtain a lien on property not yet in existence. At most, a lien creditor could only obtain a lien on the right to receive property to be received in the future. This lien would be

subordinate to the Bank's previously perfected security interest in the Leases, which by definition includes the right to payment of the monetary obligation embodied in each Lease. "An attaching creditor's rights cannot rise higher than those which the defendant named in the process had against the garnishee." *Frazier v. Berg*, 306 Pa. 317, 328-29, 159 A. 541, 543 (1932). In this case the Debtor's rights to the Lease Payments on the Petition Date were subject to the Bank's lien, which cannot be primed by the Trustee as an attaching creditor.

By virtue of its superior rights to the Leases, it would be anomalous to conclude that the Bank did not also have a superior interest in the Lease Payments as they are received by the Debtor. Yet, the UCC requires perfection in proceeds of various forms of original collateral, including various forms of rights to payment, notwithstanding perfection in the original collateral. Therefore, for the reasons set forth herein, the Bank's perfected security interest in the Leases would have been potentially meaningless if the Bank had not taken steps to continue its perfected security interest in the Lease Payments within ten days after their receipt by BFG.

The extent of the Trustee's rights and powers with respect to the Lease Payments would appear to be governed by New York law because it appears that the such Lease Payments exist, or will exist, in New York, where BFG's offices are. A lien creditor's rights and powers with respect to the Lease Payments must be subject to the Bank's right to be paid those Lease Payments. As professor Siegel states,

For purposes of execution after judgment as well as attachment before judgment, the judgment creditor's . . . right to a given item of property is deemed co-extensive with--the same as--the judgment debtor's . . . own interest in it. The theory is that the judgment creditor steps into the shoes of the judgment debtor. If the item is subject to any outstanding commitment honestly incurred (i.e., without fraud on creditors), the judgment creditor is bound by it and can assert an interest in the item only to the extent that an interest remains after the commitment is subtracted. If the item is subject to a mortgage, or to a pledge, or

to any senior lien, and the same is binding on the judgment debtor, it binds the judgment creditor as well.

Siegel, Practice Commentaries, McKinney's Cons. Laws of NY, Book 7B, C5201:15, at 4.

Stated another way, "to the extent property is subject to a perfected security interest, the monetary value of such security is an ' . . . equitable interest in such property that the debtor does not hold.'" *In re Green*, 64 B.R. 462, 465 (Bankr. S.D.Ind. 1986) (emphasis in original); see also *In re Drexel Burnham Lambert Group, Inc.*, 120 B.R. 724, 736 (Bankr. S.D.N.Y. 1990). As a result, at least one New York court has indicated that a creditor cannot effect a levy on fully encumbered property. See *William Iselin & Co., Inc. v. Burgess & Leigh Ltd.*, 52 Misc.2d 821, 276 N.Y.S.2d 659 (N.Y.Sup.Ct. 1967). In the present situation, while the debt owing under the Leases is encumbered by the Bank's perfected security interest as of the Petition Date, realization of the value of that security interest is dependent upon the Bank taking steps to continue its perfected security interest in the Lease Payments once they are received. In other words, there is potential value which can be levied upon by the lien creditor for whatever it may be worth. In this case, however, to the extent that the Bank perfected in the Lease Payments there is no value for a hypothetical creditor to levy upon. Thus, the Trustee will be unable pursuant to Code § 544 to avoid the Bank's security interest in those Lease Payments received within ten days prior to April 25, 1996, or in those received thereafter, to the extent that they are identifiable.

II. Relief from the Automatic Stay

A. Code § 362(d)

Based on the Court's reconsideration and its conclusion that the Bank has a perfected security interest in the Lease Payments to the extent discussed herein, the Court must also address

the issue of whether to modify or lift the automatic stay pursuant to Code § 362(d) to allow the Bank to receive the Lease Payments. Code § 362(d) provides for alternative bases on which a creditor may obtain relief from the automatic stay. Code § 362(d)(1) allows for relief upon a determination that “cause” exists. Under Code § 362(d)(2) relief is possible if there is a lack of equity in the collateral *and* the collateral is not necessary to the debtor’s effective reorganization. The decision to modify or lift the automatic stay is within the discretion of the Court and is to be determined on a case-by-case basis. *See In re Robbins*, 964 F.2d 342, 345 (4th Cir. 1992); *see also Sonmax Indus., Inc. v. Tri Component Prods. Corp. (In re Sonmax Indus., Inc.)*, 907 F.2d 1280, 1286 (2d Cir. 1990) (citations omitted).

The Bankruptcy Code does not define what constitutes “cause” pursuant to § 362(d)(1), other than indicating that a lack of adequate protection may serve as one basis. Normally the issue of a debtor’s reorganization is addressed pursuant to Code § 362(d)(2). In certain circumstances, however, the lack of an intent to reorganize may constitute “cause” under Code § 362(d)(1).

Under Code § 362(d)(2) the question of whether the collateral is necessary for an effective reorganization requires an initial finding that the debtor intends to reorganize. In this case, whether or not there is a reasonable possibility for a successful reorganization of the Debtor standing alone is not entirely clear. At the Hearing, the Trustee did not present any testimony to the effect that the Lease Payments themselves, as distinguished from the *collection* of the Lease Payments, are to be utilized in any reorganization of the Debtor. The Trustee has never sought authorization to use the Lease Payments. His main focus at the evidentiary hearing was on the servicing and collection operations of The Processing Center (“TPC”), also a chapter 11

debtor. His testimony in large part centered not on the Debtor's reorganization but on the continued viability and future growth of Resort Funding, Inc. ("RFI"), a related nondebtor, which utilizes the services of TPC. He indicated that the key to expansion of RFI, as distinguished from BFG, rested in large degree on being able to maintain an efficient and cost effective operation for collecting and servicing the lease accounts. He did, however, allude to the possibility that the Debtor may ultimately become involved with additional leasing operations in connection with the resort timeshare industry.

Because there was no proof that the Trustee intends to reorganize BFG, a Code § 362(d)(2) analysis is unnecessary. The Court finds that the lack of an intent to reorganize the Debtor utilizing the Lease Payments constitutes cause under Code § 362(d)(1) to grant relief from the automatic stay. To conclude otherwise would allow the Trustee to withhold non-essential collateral simply because that collateral is worth more than the balance due on the obligation it secures. In addition, there is the possibility that further delay in requiring the Trustee to turn over the Lease Payments to the Bank may increase the Bank's secured claim, should it be determined that it is oversecured, to the detriment of the investor creditor body. The Court concludes that the stay should be modified to require the Trustee to turn over the Lease Payments to the Bank, subject to the limitations set forth below.¹⁶

¹⁶ As he has in connection with previous bank motions in this case, the Trustee has argued that the Motion for Relief must be denied as a result of the operation of Code § 502(d), which generally mandates disallowance of a claim against the estate by an entity who has not turned over property recoverable as, *inter alia*, a preferential transfer pursuant to Code §§ 547 and 550. *See* 11 U.S.C. § 502(d). On April 22, 1997, the Trustee filed an adversary complaint against the Bank in which he alleges transfers from the Debtor to the Bank in the aggregate amount of at least \$358,035.36 which he contends are avoidable and recoverable pursuant to Code §§ 547 and 550. Rather than make a determination concerning the merits of the Trustee's adversary proceeding in this case, the Court will allow the Trustee to continue to hold and

Nevertheless, the Court has serious concerns about the potentially adverse impact on the Debtor's operations if the Court were to lift the stay to allow the Bank to collect Lease Payments directly from the lessees. The Court received testimony from Daniel Casey ("Casey"), the Director of Collections for TPC, who has managed the collection of delinquent lease payments for the Debtor since May 1996. Casey testified that several lessees have multiple leases which have been assigned to a number of different banks and/or private investors. In Casey's opinion, if individual banks were allowed to collect directly from the lessees, lessees which are currently forwarding a single monthly payment to the Debtor covering several leases would be faced with having to send several payments to several different lenders, which would lead to confusion and increased rates of default. Casey also expressed concern that there might be a disruption in the servicing of the leased equipment because servicing fees are a component of the lease payments and servicers would therefore have a difficult time keeping track of whether service payments on specific equipment had been made to various banks. Casey envisioned payment delays and/or defaults if lessees were to experience problems getting their equipment serviced. According to Casey, direct collection by the banks would also create problems in collecting that portion of the monthly lease payments which are earmarked for remittance to taxing authorities.

Allowing the Bank to service its portfolios not only would put at risk the collection of servicing payments and tax payments, it also has the potential for negatively impacting on any profit or spread the Trustee might be able to generate for payment to private investors, of which there are allegedly thousands. Therefore, the Court concludes that the Trustee should be allowed to continue the servicing and collection of the Bank's lease portfolios in order to minimize the

segregate \$358,035.36, pending entry of a final order in said adversary proceeding.

serious disruption that will likely occur to the detriment of secured and unsecured creditors alike if the servicing and collection functions are returned to individual lenders such as Marine.

B. Code § 552(b)

The Trustee argues that pursuant to Code § 552(b), the Court “should make the hard and imperfect decision of adjusting the equities among all those -- bank and non-bank individuals -- hurt by the Ponzi scheme” by limiting the scope of the Bank's security interest in the Lease Payments even if the Bank is perfected in the Lease Payments. *See* Trustee's Trial Brief, filed March 21, 1997, at 61. The Trustee's argues that the Bank effectively helped the Debtor in perpetrating what has been characterized as the largest Ponzi scheme in United States history by allowing the Debtor unfettered and unmonitored control of the cash advanced in connection with the transactions at issue.

The Court was presented with extensive declaration testimony by the Trustee's expert, George Davis, concerning what the Bank failed to do which may in some way have prevented the alleged fraud. The Trustee, however, not allege that the Bank's conduct was in any way fraudulent, merely less than prudent. The Bank correctly asserts that the law does not condition enforcement of a security interest on the secured party's prudence in advancing funds and monitoring prospects for repayment.

The Court has examined the legislative history and case law addressing Code § 552(b). As one court has noted,

“The purpose of the equity exception is to prevent a secured creditor from reaping benefits from collateral that has appreciated in value as a result of the trustee's/debtor-in-possession's use of other assets of the estate (which would normally go to general creditors) to cause the appreciated value.”

In re Airport Inn Associates., Ltd., 132 B.R. 951, 959 (Bankr. D.Colo. 1990) (quoting *Delbridge v. Production Credit Assn. and Federal Land Bank*, 104 B.R. 824, 826 (E.D.Mich. 1989) (emphasis added); see also *In re Patio & Porch Systems, Inc.*, 194 B.R. 569, 575 (Bankr. D.Md. 1996) (indicating that the “provision is intended to prevent secured creditors from receiving windfalls and to allow bankruptcy courts broad discretion in balancing the interests of secured creditors against the general policy of the Bankruptcy Code, which favors giving debtors a ‘fresh start’”) (citations omitted)). There is no evidence that the collateral has in any way appreciated in value since the commencement of the case or that the Bank will receive a windfall as a result of the Trustee’s actions. The fact that the amount of money held by the Trustee in the segregated account has increased is simply the result of the Trustee’s compliance with the Segregation Order requiring the deposit of the Lease Payments as they are received by the Debtor. Because each Lease is for a limited term, as the right to payment is converted into actual Lease Payments and deposited by the Debtor/Trustee, there is a resultant decrease in the number of payments remaining under the Lease and the value of each Lease is reduced accordingly. Based upon the foregoing, the Court will not limit the scope of the Bank’s security interest in the Lease Payments on the basis that the Bank may have been less than prudent in connection with the advancement of funds to the Debtor.

The Trustee also invokes the “equities of the case” provision of Code § 552(b) to argue that, if the Court determines that the Bank has a perfected security interest in the Lease Payments, a portion of the Lease Payments should be used cover the costs incurred by the Trustee in collecting the Lease Payments. The Trustee maintains that such costs are between \$6.30 and \$6.50 of the Lease Payments per lease per month, plus outside professional fees which bring the

total cost to over \$12.00 per lease, per month.

Admittedly, the generation of the Lease Payments has involved the use of assets of the estate to collect and service the lease portfolios of the Bank. However, “[a]s the House Report to the most recent amendments to 11 U.S.C. § 552 notes, 11 U.S.C. § 506(c) permits a broad range of operating expense to be deducted from pledged revenues, including those that may be subject to postpetition security interests.” *Id.* (citing H.R. Rep. 103-834, 103d Cong., 2d Sess. 27-29; 140 Cong. Rec. H 10768 (Oct. 4, 1994), *as reported in Norton Bankr. Law & Practice* 2d, p. 671 (1995-96 ed.)).

Rather than rely on Code § 552(b), the Court will consider allowing the Trustee to recover some of the expenses incurred by the estate in the collection and servicing of the Leases pursuant to Code § 506(c). Generally, expenses incurred in the administration of a debtor’s estate are the responsibility of the estate and not chargeable to the secured creditors. *See General Electric Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)* 739 F.2d 73, 76 (2d Cir. 1984). Code § 506(c) allows the estate to recover such expenses to the extent that “they are reasonable, necessary costs and expenses of . . . disposing of such property to the extent of any benefit to the holder of such claim.” *See id.* As discussed in the October Decision, the Lease Payments arose as a result of the disposition of the underlying collateral, namely the Leases. Arguably, the Bank would have incurred certain costs and expenses if it had been permitted to handle the collection process itself. However, in the view of the Court, by allowing the Trustee to continue the process, the Bank, as well as other secured and unsecured creditors, has benefitted by the minimization of disruption and chaos which would have occurred if the banks attempted to redirect the lease payments and begin the collection process on their own. As Casey testified,

\$1,595,713.89 had been collected on the Leases as of January 31, 1997, including \$1,250,138.82 attributable to Schedule A Payments. *See* Trustee's Exhibit Casey I. Based upon the evidence in the record, *see* Trustee's Exhibit F (Darefsky Declaration) at ¶ 19 and Exhibit E attached thereto, the Court concludes that \$6.31 per lease per month, is a reasonable charge that should be borne by the Bank in connection with the collection of the Lease Payments in which the Court has determined it has a valid security interest.

III. Setoff

As mentioned above, the Bank also seeks to setoff funds held in two advance payment accounts (each a "Payment Account" and collectively, the "Payment Accounts") established pursuant to "Payment Account Agreements" prepared, executed and presented by the Debtor in connection with each transaction. *See* ESB's Exhibits 4, 11, 18, 25, 32, 39, 48, 55, 62 and 69. The Payment Accounts were meant to provide a convenient mechanism for repayment of the amounts owing to the Bank under the Promissory Notes. Pursuant to the Payment Account Agreements, the Debtor apparently deposited monies into the Payment Accounts and granted the Bank a security interest in monies on deposit equal to one month's advance payment due under the notes. The Bank would then automatically deduct this payment from the Payment Account each month when it came due.

The Bank seeks relief from the stay to setoff, pursuant to Code § 553, the amounts in the Payment Accounts against the amounts which it is owed by the Debtor. The Trustee argues that the Bank is not entitled to exercise any right of setoff because the debts in question are not "mutual debts" within the meaning of Code § 553. The Trustee further argues that, even if the

debts in question are mutual, setoff is precluded by Code § 553(a)(3), because a portion of the funds in the Payment Accounts constitute debts incurred for the purpose of obtaining a right of setoff against the Debtor, because the Debtor intentionally declined to withdraw funds from the Payment Accounts during the 90 days preceding the Petition Date.¹⁷ See Trustee's Trial Memorandum, at 64-69.

The Debtor's financing transactions with many, if not all, of the banks in this case are characterized by the establishment of advance payment accounts pursuant to payment account agreements similar, if not identical, to the Payment Account Agreements now in question. On facts and arguments largely identical to those now being presented here, the Court, by Memorandum-Decision, Findings of Fact, Conclusions of Law and Order dated November 15, 1996 (the "November 15, 1996 Decision"), granted Manufacturers and Traders Trust Company relief from the automatic stay to setoff funds held in an advance payment account against funds owing from the Debtor. The Court's November 15, 1996 Decision was affirmed on September 12, 1997 by the United States Bankruptcy Appellate Panel for the Second Circuit (the

¹⁷ Code § 553 provides in pertinent part:

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor that arose before the commencement of the case, except to the extent that--

...

- (3) the debt owed to the debtor by such creditor was incurred by such creditor---
 - (A) after 90 days before the date of the filing of the petition;
 - (B) while the debtor was insolvent; and
 - (C) for the purpose of obtaining a right of setoff against the debtor.

...

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

"Bankruptcy Appellate Panel"). *See Breeden v. Manufacturers and Traders Trust Co. (In re The Bennett Funding Group, Inc.)*, BAP Nos. 96-50040 and 96-50041 (2d Cir. BAP Sept. 12, 1997) (the "M & T Decision").¹⁸ In the M & T Decision, the Bankruptcy Appellate Panel concluded that mutual debts existed by virtue of funds held in the advance payment account in question. *See id.* at 22. Also, the Bankruptcy Appellate Panel expressly rejected the contention that the funds in the payment accounts had been intentionally built-up for the purpose of obtaining a right of setoff. *See id.* at 24-25. Based upon the foregoing, and for the reasons more fully set forth in this Court's November 15, 1996 Decision and in the M & T Decision, the Court will grant the Bank relief from the automatic stay to setoff any funds which may be in the Payment Accounts.¹⁹ The Court makes no determination, however, as to the amount, if any, of funds in the Payment Accounts, but notes that the Trustee does not appear to dispute the existence of funds in the Payment Accounts. Based on the foregoing, it is

ORDERED that pursuant to Code § 362(d)(1), the automatic stay is hereby modified to the extent that the Trustee is required to turn over to the Bank that portion of the segregated account that represents Schedule A Payments collected on the Leases since May 22, 1996, with

¹⁸ This was a consolidated appeal. The Trustee filed his notice of appeal on November 25, 1996 (BAP 96-50040); the Committee filed its notice of appeal on December 3, 1996 (BAP 96-50041).

¹⁹ The Trustee, in his adversary complaint filed April 22, 1997, alleges that the Bank transferred to itself \$195,225.48 from the Payment Accounts, and that such transfers are avoidable and recoverable pursuant to Code §§ 547 and 550. The Court is not prepared to make a determination as to the merits of this claim in the context of the instant Motion for Relief. In view of the Bankruptcy Appellate Panel's ruling and the fact that some of this \$195,225.48 may also comprise some of the \$358,035.36 allegedly paid by the Debtor to the Bank within 90 days prepetition, see note 24, *supra*, the Court will not require the Bank to continue to escrow any of the monies currently held in the Payment Accounts pending entry of a final order in the Trustee's adversary proceeding.

the exception of Lease number 93080637, exclusive of any interest earned thereon, within thirty (30) days of the date of this Order, and to turn over on a monthly basis as of the date of this Decision all Schedule A Payments collected on those Leases in which the Bank has established a perfected security interest consistent with the discussion herein without prejudice to the Bank's right to assert a claim for interest and attorney's fees at the time of confirmation of a plan or at such other time as the Court may deem appropriate.²⁰ Said payments shall not exceed, however, the principal amount of the Bank's claims as of March 29, 1996;²¹ it is further

ORDERED that the Trustee, utilizing The Processing Center, shall continue to service and collect on the Leases subject to the Bank's security interest and shall also continue to provide the Bank with monthly reports which shall detail and support said collections; it is further

ORDERED that pursuant to Code § 506(c), the Trustee shall be permitted to deduct from the remittance of monthly Schedule A Payments already collected, as well as those to be collected, the cost of servicing/collecting on the Leases at the rate of \$6.31 per Lease per month, subject to being adjusted upon a later order of the Court with the proviso that if monthly

²⁰ Because the Court has found cause to grant the Bank's Motion for Relief pursuant to Code § 362(d)(1), the Court has made no finding concerning whether the Debtor has any equity in the Leases/Lease Payments pursuant to Code § 362(d)(2)(A). Nor has the Court made any finding with regard to any interest the Bank may have in collateral other than the Lease Payments as defined herein. To the extent that the Court has heard valuation testimony, the Court will utilize it in ultimately determining the full amount of the Bank's secured claim pursuant to Code § 506(a) as well as whether the Bank is oversecured pursuant to Code § 506(b), at confirmation or such time as the Court deems it to be appropriate.

²¹ Because the Court has concluded that the Bank is entitled to receive any identifiable Lease Payments received by the Debtor within ten days of the filing of the Bank's Motion for Relief and all identifiable Lease Payments received thereafter, the Court finds it unnecessary to grant the Bank's request for adequate protection.

collection on any single lease is not sufficient to pay the Bank the full amount of its Schedule A Payment, the rate for servicing that particular lease will be reduced proportionately;²² it is further

ORDERED that the Trustee shall provide the Bank with a monthly accounting which shall indicate the manner in which the amount of the monthly check has been calculated by the Trustee; it is further

ORDERED that, subject to further Order of this Court, the Trustee shall withhold from the Schedule A Payments collected on behalf of the Bank the sum of \$358,035.36, which he alleges constitute preference payments received by the Bank; it is further

ORDERED that to the extent that the Bank has monies on deposit in any Payment Account, it shall be entitled to set off those monies against the principal amount of the Bank's claims as of March 29, 1996 without prejudice to the Trustee to seek disgorgement of any monies which the Court may later find to be recoverable by the Trustee; and it is finally

ORDERED that with regard to any monies currently being collected by the Trustee on the Leases which may be subject to the Bank's security interest not addressed in this Order, said monies shall continue to be collected and held or disbursed in accordance with the prior orders of this Court.²³

²² For example, if the Schedule A payment to be made to Marine on a single lease is \$100 and the Trustee has sufficient collections to permit the payment of \$80.00, or 80% of what is due Marine, then the Trustee shall deduct only \$5.05 (80% x \$6.31) from the Schedule A payment of \$80 for that particular lease.

²³ These include, *inter alia*, payments for the servicing and maintenance of the leased equipment and payments due to taxing authorities.

Dated at Utica, New York

this 15th day of October 1997

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge